

for which an application under section 6411(d) is being made. The taxpayer must attach to the form a separate schedule containing the information required under paragraph (d) of this section.

(2) *Applications made before February 7, 1980.* Applications made before February 7, 1980 that are made under penalties of perjury will be considered meeting the requirements of this section if made by filing a separate statement whether or not it is attached to Form 1139 or 1045. This application, however, must contain the information required under paragraph (d) of this section (other than paragraph (d)(2)).

(d) *Information required*—(1) *In general.* The application must contain (i) the taxpayer's name, address, and identification number and (ii) the information set forth in paragraph (d) (2) and (3) of this section, determined in accordance with section 1341 and the regulations under that section. For example, the decrease in tax under paragraph (d)(3)(iii) of this section is determined under §1.1341-1(d)(4).

(2) *Computation under section 1341(a)(4).* The application must contain the following information related to the computation under section 1341(a)(4):

(i) The amount of income restored by the taxpayer to another during the taxable year and the amount of the corresponding deduction described in section 1341(a)(2);

(ii) The tax for the taxable year computed with the deduction described in section 1341(a)(2); and

(iii) The tax for each prior taxable year (determined before adjustment under section 1341) to which any net operating loss described in section 1341(b)(4)(A) may be carried and the decrease in tax for each of those years that results from the carryback of that loss.

(3) *Computation under section 1341(a)(5).* The application must contain the following information related to the computation under section 1341(a)(5):

(i) The tax for the taxable year without the deduction described in section 1341(a)(2);

(ii) The tax for each prior taxable year (determined before adjustment

under section 1341) for which a decrease in tax is computed under section 1341(a)(5)(B);

(iii) The decrease in tax for each prior taxable year computed under section 1341(a)(5)(B), including any decrease resulting from a net operating loss or capital loss described in section 1341(b)(4)(B); and

(iv) The amount treated as an overpayment of tax under section 1341(b)(1).

(e) *Time and place for filing.* The application must be filed no earlier than the date of filing the return for the taxable year of restoration and no later than the date 12 months from the last day of that taxable year. The application must be filed with the Internal Revenue Service Center (or other office) where the taxpayer filed its return for the taxable year of restoration.

(f) *Not a claim for credit or refund.* An application for tentative refund under section 6411(d) is not a claim for credit or refund. The principles of paragraph (b)(2) of §1.6411-1 apply in determining the effect of an application for a tentative refund. For example, the filing of an application for tentative refund under section 6411(d) is not a claim for credit or refund in determining whether a claim for credit or refund was timely filed.

[T.D. 7672, 45 FR 8295, Feb. 7, 1980; 45 FR 17138, Mar. 18, 1980]

## PART 5c—TEMPORARY INCOME TAX REGULATIONS UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981

Sec.

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5c.1305-1 Special income averaging rules for taxpayers otherwise required to compute tax in accordance with § 5c.1256-3.

AUTHORITY: 26 U.S.C. 168(f)(8)(G) and 7805.

SOURCE: T.D. 7791, 46 FR 51907, Oct. 23, 1981, unless otherwise noted.

### § 5c.44F-1 Leases and qualified research expenses.

For purposes of section 44F(b)(2)(A)(iii), the determination of whether any amount is paid or incurred to another person for the right to use personal property in the conduct of qualified research shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8). See § 5c.168(f)(8)-1(b).

### § 5c.103-1 Leases and capital expenditures.

For purposes of section 103(b)(6)(D) and § 1.103-10(b)(2)(iv)(b), the determination of whether property is leased and whether property is of a type that is ordinarily subject to a lease shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8).

### § 5c.103-2 Leases and industrial development bonds.

For purposes of section 103(b)(2), the determination of whether an obligation constitutes an industrial development bond shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8).

[T.D. 7800, 46 FR 63257, Dec. 31, 1981]

### § 5c.103-3 Leases and arbitrage.

In the case of a sale and leaseback transaction qualifying under section 168(f)(8), where the lessee's rental payments are substantially equal in timing and amount to the principal and interest payments on the lessor's note, the arbitrage provisions of section 103(c) and §§ 1.103-13, 1.103-14, and 1.103-15 shall apply to any obligations of the lessee (or party related to the lessee)

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without regard to the section 168(f)(8) lease transaction.

[T.D. 7800, 46 FR 63257, Dec. 31, 1981]

### § 5c.168(f)(8)-1 Special rules for leases.

(a) *In general.* Section 168(f)(8) of the Internal Revenue Code of 1954 provides special rules for characterizing certain agreements as leases and characterizing the parties to the agreement as lessors and lessees for Federal tax law purposes. These rules apply only with respect to qualified leased property. If all the requirements of section 168(f)(8) and §§ 5c.168(f)(8)-2 through 5c.168(f)(8)-11 are met, then the agreement shall be treated as a lease, and the party characterized as the lessor shall be treated as the owner of the property. In such case, the lessor shall be deemed to have entered into the lease in the course of carrying on a trade or business and shall be allowed accelerated cost recovery system (ACRS) deductions under section 168 and the investment tax credit under section 38 with respect to the leased property.

(b) *Exception for qualified research expenditures.* For purposes of section 44F(b)(2)(A)(iii), the determination of whether any amount is paid or incurred to another person for the right to use personal property in the conduct of qualified research shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8). Thus, if a lessee would be considered the owner of the property without regard to section 168(f)(8), any amounts paid by the lessee under the lease shall not be considered amounts paid or incurred for the right to use the property.

(c) *Other factors disregarded.* If an agreement meets the requirements of section 168(f)(8) and §§ 5c.168(f)(8)-2 through 5c.168(f)(8)-11, the following factors will not be taken into account in determining whether the transaction is a lease:

(1) Whether the lessor or lessee must take the tax benefits into account in order to determine that a profit is made from the transaction;

(2) The fact that the lessee is the nominal owner of the property for State or local law purposes (*e.g.*, has legal title to the property) and retains the burdens, benefits, and incidents of

ownership (such as payment of taxes and maintenance charges with respect to the property);

(3) Whether or not a person other than the lessee may be able to use the property after the lease term;

(4) The fact that the property may (or must) be bought or sold at the end of the lease term at a fixed or determinable price that is more or less than its fair market value at that time;

(5) The fact that the lessee or related party has provided financing or has guaranteed financing for the transaction (other than for the lessor's minimum 10 percent investment); and

(6) The fact that the obligation of any person is subject to any contingency or offset agreement. See, for example, the rent and debt service offset in Example (2) of paragraph (e).

An agreement that meets the requirements of section 168(f)(8) and §§ 5c.168(f)(8)-2 through 5c.168(f)(8)-11 may be treated by the parties as a lease for Federal Tax law purposes only. Similarly, a sale by the lessee of the leased property to the lessor in a transaction where the property is leased back under an agreement that meets the requirements of section 168(f)(8) may be treated by the parties as a sale for Federal tax law purposes only. The agreements need not comply with State law requirements concerning transfer of title, recording, etc.

(d) *Ownership in one of the parties.* Notwithstanding any other section, if neither the lessor nor the lessee would be the owner of the property without regard to section 168(f)(8), or, if any party with an economic interest in the property (other than the lessor or lessee or any subsequent transferee of their interests) claims ACRS deductions or any investment tax credit with respect to the leased property, an election under section 168(f)(8) with respect to such property shall be void as of the date of the execution of the lease agreement.

(e) *Examples.* The application of section 168(f)(8) and §§ 5c.168(f)(8)-2 through 5c.168(f)(8)-11 may be illustrated by the following examples:

*Example (1).* X Corp. wishes to acquire a \$1 million piece of equipment which is "qualified leased property" as defined in section 168(f)(8)(D). The equipment has a 10-year eco-

nomic life and falls within the 5-year ACRS class. Y Corp. is a person meeting the qualifications set forth in section 168(f)(8)(B)(i) and § 5c.168(f)(8)-3 and wishes to be the owner of the property for Federal tax law purposes. Y therefore purchases the equipment from the manufacturer for \$1 million, paying \$200,000 in cash and borrowing \$800,000 from a bank (payable over 9 years and requiring nine equal annual payments of principal and interest of \$168,000). Y then leases the equipment to X under an agreement providing for nine annual rental payments of \$168,000, and the parties elect in accordance with the provisions of § 5c.168(f)(8)-2 to have the provisions of section 168(f)(8) apply. The timing and amount of the rental payments required to be made by X (the "lessee-user") under the lease will be exactly equal to the timing and amount of the principal and interest payments that Y (the "lessor") will be required to make to the bank under its purchase money note. Under these circumstances, Y is treated as the owner and lessor of the property for Federal tax law purposes; it therefore is entitled to the investment tax credit and the ACRS deductions with respect to the property. Y's basis in the property is \$1 million. Y must report the rent as income and will be entitled to deduct the interest on the purchase money note. The aggregate payments required to be made by X under the lease are treated as rent in accordance with § 5c.168(f)(8)-7 and are deductible as such.

*Example (2).* The facts are the same as in example (1) except that X purchases the equipment for \$1 million and wishes to transfer ownership of the property for Federal tax law purposes to Y under a sale and leaseback arrangement. Accordingly, X sells the property to Y for \$200,000 in cash (which represents the agreed upon compensation for the tax benefits to be enjoyed by Y as lessor) plus a 9-year, \$800,000 note calling for nine \$168,000 annual payments of principal and interest. Y then leases the property back to X under an agreement providing for nine annual rental payments of \$168,000. The parties elect in accordance with the provisions of § 5c.168(f)(8)-2 to have the provisions of section 168(f)(8) apply. The timing and amount of the rental payments required to be made by X (as the lessee-user) under the lease will be exactly equal to the timing and amount of the principal and interest payments that Y will be required to make to X under Y's purchase money note, so that the only cash transferred between X and Y is the \$200,000 down payment. Y's obligation to make debt service payments on the note is contingent on X's obligation to make rental payments under the lease. Under these circumstances, Y is treated as the owner and lessor of the property for Federal tax law purposes; it therefore is entitled to the investment tax credit and ACRS deductions with respect to

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the property. Y's basis in the property is \$1 million. Y must report the rent as income and will be entitled to deduct the interest on the purchase money note. No gain or loss will be recognized by X on the sale of the property since the sale price equals X's basis in the property. X must report as income the interest paid by Y on the note and will be entitled to a deduction for the rental payments it makes under the lease in accordance with §5c.168(f)(8)–7.

*Example (3).* Assume that in both examples (1) and (2) X has an option to purchase the equipment at the end of the lease term for \$1.00. The fact that the property may (or must) be bought or sold at the end of the lease term at a fixed or determinable price that is more or less than its fair market value is not taken into account in determining the status of the transactions as leases under section 168(f)(8).

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56148, Nov. 13, 1981]

### §5c.168(f)(8)–2 Election to characterize transaction as a section 168(f)(8) lease.

(a) *Election*—(1) *In general.* The election to characterize a transaction as a lease qualifying under section 168(f)(8) shall be made within the time and manner as set forth in this section without regard to section 168(f)(4).

(2) *Lease agreement.* For an agreement to be treated as a lease under section 168(f)(8) and this section, the lease agreement must be executed not later than 3 months after the property was first placed in service, as defined in §5c.168(f)(8)–6(b)(2)(i) (or prior to November 14, 1981, if the property was first placed in service by the lessee after December 31, 1980, and before August 14, 1981). The agreement must be in writing and must state that all of the parties to the agreement agree to characterize it as a lease for purposes of Federal tax law and elect to have the provisions of section 168(f)(8) apply to the transaction. The agreement must also name the party who will be treated as the lessor and the party who will be treated as the lessee.

(3) *Information return concerning the election.* (i) Except as provided in subdivision (ii), for each lease agreement, the lessor and lessee must jointly file Form 6793, Safe Harbor Lease Information Return, concerning their election under section 168(f)(8). The information return must be signed by both the lessor

and the lessee and filed not later than the 30th day after the agreement is executed with the Commissioner of Internal Revenue, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attn: Form 6793). Unless the failure to file timely is shown to be due to reasonable cause, the failure to file the information return timely shall void the section 168(f)(8) election as of the date of the execution of the lease agreement. The information return shall include the following items:

(A) The name, address, and taxpayer identifying number of the lessor and the lessee (and the common parent company if a consolidated return is filed);

(B) The service center with which the income tax returns of the lessor and lessee are filed;

(C) A description of each property with respect to which the election is made;

(D) The date on which the lessee places the property in service (determined as defined in §5c.168(f)(8)–6(b)(2)(i)), the date on which the lease begins, and the term of the lease;

(E) The recovery property class of the leased property under section 168(c)(2) (for example, 5 years) and the ADR midpoint life of the leased property;

(F) The terms of the payments between the parties to the lease transaction;

(G) Whether the ACRS deductions and the investment tax credit are allowable to the same taxpayer;

(H) The aggregate amount paid to outside parties to arrange or carry out the transaction, such as, for example, legal and investment banking fees;

(I) For the lessor only: The unadjusted basis of the property as defined in section 168(d)(1);

(J) For the lessor only: If the lessor is a partnership or a grantor trust, the name, address, and taxpayer identifying number of the partners or the beneficiaries, and the Service Center with which the income tax return of each partner or beneficiary is filed; and

(K) Such other information as may be required by the return or its instructions.

The aggregate amount paid to outside parties which is described in paragraph

(a)(3)(i)(H) of this section need not be disclosed unless it is reasonable to estimate that either the lessor or the lessee will lease property under section 168(f)(8) for the calendar year which has an aggregate adjusted basis to such person of more than \$1,000,000. If either the lessor or the lessee reasonably expects to lease property with an aggregate basis of more than \$1,000,000, then both parties must disclose their transaction costs.

(ii) In the case of an agreement executed before January 1, 1982, only the lessor is required to file the information return described in paragraph (a)(3)(i) of this section and the return must be postmarked not later than January 31, 1982. Unless the failure to file timely is shown to be due to reasonable cause, or unless the lessee files the information return postmarked by January 31, 1982, the lessor's failure to file the information return timely shall be a disqualifying event as of February 1, 1982, which shall cause an agreement to cease to be treated as a lease under section 168(f)(8). For the Federal income tax consequences of a disqualifying event, see § 5c.168(f)(8)-8.

(iii) A copy of the information return described in paragraph (a)(3)(i) and (ii) shall be filed by each party with its timely filed Federal income tax return for its taxable year during which the lease term begins. However, for taxable years ending in 1981 with respect to lease agreements executed during calendar year 1981, such statement shall be filed by the later of (A) the due date (taking extensions into account) of the party's 1981 Federal income tax return, or (B) where the filing of an amended return is required, with the amended return within 3 months following the execution of the lease agreement. For the requirement to file an amended return within 3 months and the consequences of the failure to so file, see § 5c.168(f)(8)-6(b)(2)(ii). A taxpayer that is required to file the information return with its Federal income tax return before an information return form is available shall file, in lieu of the required information return, a statement which contains the information set forth in subparagraphs (A) through (J) of paragraph (a)(3)(i). The failure by the lessor to file the information return

(or, if applicable, the statement referred to in the preceding sentence) with its timely filed Federal income tax return shall be a disqualifying event which shall cause an agreement to cease to be treated as a lease under section 168(f)(8). For the Federal income tax consequences of a disqualifying event, see § 5c.168(f)(8)-8.

(4) *Election is irrevocable.* An agreement made pursuant to paragraph (a)(2) of this section shall be irrevocable as of the later of the date such agreement was executed or November 23, 1981.

(5) *Disposition by lessee.* Except in the case of transactions described in subparagraph (6), of this paragraph, if the lessee (or any transferee of the lessee's interest) sells or assigns its interest in the lease or in the property, the agreement will cease to be characterized as a lease under section 168(f)(8) as of the time of the sale or assignment unless the transferee furnishes to the lessor within 60 days following the transfer the transferee's written consent to take the property subject to the lease, and the transferee and lessor file a statement with their timely filed Federal income tax returns for the taxable year in which the transfer occurs containing the following information:

(i) The name, address, and taxpayer identifying number of the lessor and the transferee;

(ii) The district director's office with which the income tax returns of the lessor and transferee are filed;

(iii) A description of the property; and

(iv) Confirmation of the transferee's consent.

See § 5c.168(f)(8)-8 for the Federal income tax consequence where an agreement ceases to be characterized as a lease under section 168(f)(8).

(6) *Disposition of lessee's interest in bankruptcy, etc., or similar proceeding.* In the case of an agreement executed after May 31, 1982, where the lessee's interest in the lease or in the property is sold or assigned in a bankruptcy, liquidation, receivership, a court-supervised foreclosure, or in any similar proceeding for the relief or protection of insolvent debtors in Federal or State court, the agreement will continue to

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be characterized as a lease under section 168(f)(8) and the purchaser or assignee shall take the property subject to the lease if—

(i) Prior to the consummation of the sale or assignment, the lessor gives written notice of its Federal income tax ownership to the judicial or administrative body having jurisdiction over the proceeding and to the debtor in possession of the interest or, if at such time a trustee, receiver or similar person has been appointed by the court, to the person appointed. The notice must contain a request that the court and the debtor or the person appointed provide a copy of the notice to the purchaser or assignee prior to the consummation of the sale or assignment. Within 60 days following the sale or assignment, the lessor must provide notice of its Federal income tax ownership and copies of the lease agreement, and, in the case of a sale and leaseback transaction, the lessor's purchase money obligation, to the purchaser or assignee;

(ii) The lessor files a statement with its timely filed Federal income tax return for the taxable year in which the sale or assignment occurs containing the following information:

(A) The name, address, and taxpayer identifying number of the lessor and the purchaser or assignee;

(B) The district director's office with which the Federal income tax returns of the lessor and purchaser or assignee are filed;

(C) A description of the property; and

(iii) Prior to the consummation of the sale or assignment, all secured lenders of the lessee with interests in the property, which interests arose not later than the time the lessee first used the property under the lease (and which were perfected in accordance with applicable local law), specifically either exclude or release in writing the Federal income tax ownership of the property from their interests.

The purchaser or assignee of the interest with respect to which this paragraph applies shall file a statement with its timely filed Federal income tax return for the taxable year in which the sale or assignment occurs containing the information described in subdivision (ii) of this subparagraph.

If the interest is subsequently transferred (other than in a bankruptcy, liquidation, receivership, court-supervised foreclosure, or similar proceeding) during the term of the lease, the agreement will continue to be characterized as a lease under section 168(f)(8) and the transferee will take the property subject to the lease if either (A) the lessor gives the transferee, prior to the transfer, a copy of the lease, written notice of its Federal income tax ownership, and, in the case of a sale and leaseback transaction, a copy of the lessor's purchase money obligation, and the lessor files a statement with its timely filed Federal income tax return as described in subdivision (ii) of this subparagraph, or (B) within 60 days following the transfer, the transferee agrees in writing to take the property subject to the lease and the lessor and transferee file a statement with their timely filed Federal income tax returns within the time and in the manner described in paragraph (a)(5) of this section. However, an agreement will not continue to be characterized as a lease under this subparagraph if, under another applicable provision, it would cease to be characterized as a lease. See § 5c.168(f)(8)–8 for the Federal income tax consequences where an agreement ceased to be characterized as a lease under section 168(f)(8).

(7) *Consequences of taking the property subject to the lease agreement.* For purposes of §§ 5c.168(f)(8)–1 through 5c.168(f)(8)–11, in a situation where a transferee of a lessee's interest acquires the property subject to the lease, the transferee shall be deemed to have acquired a leasehold interest in the property equal to the remaining lease term, any unpaid obligation of the lessor arising in connection with the sale of the property by the original lessee in a sale and leaseback transaction, and any option of the lessee to purchase the property. Any consideration paid by the transferee for the property shall be allocated to the lessor's obligation to the extent of the unpaid balance of the obligation. Any excess over the unpaid balance shall be

allocated between the leasehold interest and the purchase option in proportion to their relative fair market values. As the new lessee, the transferee shall not be entitled to claim any ACRS deduction with respect to the property while the lease remains in effect and shall not be entitled to any investment tax credit with respect to the property. The transferee shall report interest income on the lessor's obligation, and shall be entitled to deduct the rent paid under the lease, in accordance with § 5c.168(f)(8)-7. In addition, the transferee shall be entitled to amortize the portion of its cost allocable to the leasehold interest. Conversely, as long as the lease remains in effect, the lessor will continue to be recognized as the owner of the property for Federal income tax purposes, shall be required to report rents due under the lease, and shall be entitled to deduct interest on its obligation.

(8) *Election to treat certain leases under subparagraph (6) rules.* The lessor under a section 168(f)(8) lease executed on or before May 31, 1982, may elect to have the provisions of paragraph (a)(6) of this section apply in the case of a sale or assignment of the lessee's interest in the lease or in the property in a bankruptcy, receivership, liquidation, court-supervised foreclosure, or similar proceeding. The election of the lessor with respect to any leased property may be made at any time prior to the consummation of any sale or assignment of such property in a bankruptcy, etc., or similar proceeding, by complying with the provisions of subparagraph (6) of this paragraph.

(b) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

*Example (1).* X Corp. maintains its books and records for Federal tax law purposes on a calendar year basis. On February 1, 1981, X acquires certain equipment for use in its business, and the equipment is deemed to be placed in service on that date within the meaning of § 5c.163(f)(8)-6(b)(2)(i). On November 1, 1981, X sells the equipment to Y and leases it back under a lease in which the parties elect to have the provisions of section 168(f)(8) apply. The election is considered timely for purposes of making Y the owner of the property under section 168(f)(8) since the lease agreement was executed before November 14, 1981.

*Example (2).* The facts are the same as in example (1) except that X Corp.'s taxable year ends on February 28, 1981. X claimed the investment tax credit and depreciation deductions with respect to the property in its return filed April 1, 1981. The lease will qualify for safe harbor treatment under section 168(f)(8) provided X, within 3 months after the lease agreement was executed, files an amended return pursuant to § 5c.168(f)(8)-6(b)(2)(ii) for its taxable year ending February 28, 1981, in which X foregoes its right to claim any investment tax credit or ACRS deductions with respect to the property subject to the lease.

*Example (3).* X Corp. (as lessee) sells certain new equipment to Y Corp. (as lessor) and leases it back under a section 168(f)(8) lease. During the term of the lease X sells its interest in the property to T Corp. (other than in a bankruptcy or similar proceeding), and T does not give Y a written consent to take the property subject to the lease. The agreement ceases to be treated as a lease under section 168(f)(8) as of the date of the sale.

*Example (4).* The facts are the same as in example (3) except that the sale of the property takes place while X is under the jurisdiction of a court in a bankruptcy proceeding. All lenders of X having perfected interests in the property that arose by the time the property was first used under the lease have specifically either excluded or released the ownership of the property for Federal income tax purposes from their interests. Within the required time periods, Y gives appropriate notification to the court, the bankruptcy trustee, and T that the property is subject to the lease and files the required statement with its Federal income tax return for the taxable year in which the sale occurs. The agreement continues to be treated as a lease under section 168(f)(8). T will take the property subject to the lease. T must allocate the purchase price among the lessor's note, the leasehold interest, and the option (if any) to purchase the property.

*Example (5).* The facts are the same as in example (4), except that one lender of X having a perfected and timely interest in the property does not specifically exclude or release the Federal income tax ownership of the property from its interest. The agreement will cease to be treated as a lease under section 168(f)(8) as of the date of the transfer to T. The result would be the same if Y failed to furnish any of the notices required by subdivision (i) of paragraph (a) and (6) or failed to file a statement as required by subdivision (ii) of paragraph (a)(6).

*Example (6).* The facts are the same as in example (4). In addition, during the term of the lease T transfers the property to U Corp. and Y fails to furnish U with written notice that the property is subject to the lease prior to the sale and U refuses to agree to

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consent to the lease agreement. The agreement will cease to be treated as a lease under section 168(f)(8) as of the date of the transfer to U. The result would be the same if Y furnished U with timely written notice of its tax ownership but failed to file the required statement with its tax return for its taxable year in which the sale occurred.

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56148, Nov. 13, 1981; T.D. 7800, 46 FR 63257, Dec. 31, 1981]

#### § 5c.168(f)(8)–3 Requirements for lessor.

(a) *Qualified lessor.* In order for an agreement to be treated as a lease under section 168(f)(8), the party characterized in the agreement as the lessor must be a qualified lessor. The term “qualified lessor” means—

(1) A corporation which is neither an electing small business corporation under section 1371(b) nor a personal holding company under section 542(a), or

(2) A partnership all of whose partners are corporations described in subparagraph (1), or

(3) A grantor trust whose grantor and beneficiaries are all corporations described in paragraph (a)(1) or partnerships described in paragraph (a)(2).

(b) *Effect of disqualification of lessor.* If at any time during the term of the agreement the lessor ceases to be a qualified lessor, the agreement will lose its characterization as a lease under section 168(f)(8) as of the date of the event causing such disqualification. If any partner of a partnership described in paragraph (a)(2) ceases to be a corporation described in paragraph (a)(1), the partnership entity shall cease to be a qualified lessor. Similarly, if any beneficiary of a trust described in paragraph (a)(3) ceases to be a corporation described in paragraph (a)(1), the trust shall cease to be a qualified lessor. See § 5c.168(f)(8)–8 for the Federal income tax consequences of such a disqualification.

(c) *One tax owner per property.* Only one person may be a qualified lessor under section 168(f)(8) with respect to leased property. Thus, property that is subject to a lease under section 168(f)(8) may not be subleased under a lease for which a section 168(f)(8) election is made. In addition, if a lessor sells or assigns in a taxable transaction its in-

terest in a section 168(f)(8) lease or in the underlying property, the lease shall cease to qualify under section 168(f)(8) and no other lease may be executed under section 168(f)(8) with respect to the property. The preceding sentence applies to a sale or assignment of its interest by a partner of a lessor that is a partnership described in paragraph (a)(2) of this section or by a beneficiary of a lessor that is a trust described in paragraph (a)(3) of this section. See § 5c.168(f)(8)–8 for the Federal income tax consequences where a lease ceases to qualify under section 168(f)(8). However, lease brokers, agents, etc., may, for example, prepare executory contracts with the lessee whereby the broker’s assignee may execute a lease as lessor, and, if the requirements of section 168(f)(8) and §§ 5c.168(f)(8)–1 through 5c.168(f)(8)–11 are met, the lease will qualify under section 168(f)(8).

(d) *Examples.* The application of paragraph (c) may be illustrated by the following examples:

*Example (1).* X Corp. (as lessee) sells certain new equipment to Y Corp. (as lessor) and leases it back under a section 168(f)(8) lease. Within 3 months after the property was placed in service, Y assigns its interest in the lease to Z. Upon the transfer to Z, the lease will no longer qualify for treatment under section 168(f)(8). The property may not thereafter be the subject of a section 168(f)(8) lease.

*Example (2).* X Corp., which wishes to acquire certain equipment for use in its business and to transfer ownership of the property for Federal income tax law purposes, purchases the equipment and enters into an executory contract with LB, a lease broker, under which X agrees to execute a section 168(f)(8) lease as lessee with a third party lessor. At a later date (but within the prescribed 3-month period), LB arranges for X and T Corp. (which wishes to secure Federal income tax law ownership) to execute a lease agreement in accordance with § 5c.168(f)(8)–2. The lease will qualify for treatment under section 168(f)(8).

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56149, Nov. 13, 1981]

#### § 5c.168(f)(8)–4 Minimum investment of lessor.

(a) *Minimum investment.* Under section 168(f)(8)(B)(ii), an agreement will



not be characterized as a lease for purposes of section 168(f)(8) unless the qualified lessor has a minimum at risk investment which, at the time the property is placed in service under the lease and at all times during the term of the lease, is not less than 10 percent of the adjusted basis of the leased property. As the adjusted basis of the leased property is reduced by capital cost recovery deductions, the minimum investment required will also be reduced to 10 percent of the revised adjusted basis, until the adjusted basis has been completely recovered, at which time no minimum investment will be required. Financing provided by the lessee or a party related to the lessee, such as a recourse note given by the lessor to the lessee, will not be taken into account in determining the lessor's minimum investment.

(b) *At risk amount.* The minimum investment which the lessor has at risk with respect to the leased property for purposes of paragraph (a) of this section includes only consideration paid and recourse indebtedness incurred by the lessor to purchase the property. The lessor must have sufficient net worth (without regard to the value of any leases which qualify under section 168(f)(8)) to satisfy any personal liability incurred. Any tax benefits which the lessor derives from the leased property shall not be taken into account to reduce the amount the lessor has at risk. An agreement between the lessor and the lessee requiring either or both parties to purchase or sell the qualified leased property at some price (whether or not fixed in the agreement) at the end of the lease term shall not affect the amount the lessor has at risk with respect to the property. However, an option held by the lessor to sell the property that is exercisable before the end of the period prescribed under section 168(c)(2) for the recovery property class of the leased property (taking into account any election by the lessor or lessee under section 168(b)(3)) shall reduce the amount the lessor is considered to have at risk by the amount of the option price at the time the option becomes exercisable.

#### § 5c.168(f)(8)-5 Term of lease.

(a) *Term of lease—Basic rules.* To qualify as a lease under section 168(f)(8) and § 5c.168 (f)(8)-1 (a), the lease agreement must provide for a term that does not exceed the maximum term described in paragraph (b) of this section; such term must also at least equal the minimum term described in paragraph (c).

(b) *Maximum term.* For purposes of section 168(f)(8)(B)(iii) and this section, the term of the lease may not exceed the greater of—

(1) 90 percent of the useful life of the property under section 167, or

(2) 150 percent of the asset depreciation range (ADR) present class life ("midpoint") of such property, applicable as of January 1, 1981 (without regard to section 167(m)(4)), published in Rev. Proc. 77-10, 1977-1 C. B. 548, and revisions thereto.

Solely for purposes of this paragraph (b), "useful life" means the period when the leased asset can reasonably be expected to be economically useful in anyone's trade or business; such term does not mean the period during which the lessor expects to lease the property. Any option to extend the term of the lease, whether or not at fair market value rent, must be included in the term of the lease for purposes of this paragraph. If several different pieces of property are the subject of a single lease, the maximum allowable term for such lease will be measured with respect to the property with the shortest life. In no case, however, will the lease term qualify under this section if such term with respect to any piece of property is less than the minimum term described in paragraph (c).

(c) *Minimum term.* For purposes of this section, the term of the lease must at least equal the period prescribed under section 168(c)(2) for the recovery property class of the leased property. For example, if a piece of leased equipment is in the 5-year recovery property class, the lease agreement must have a minimum term of 5 years. In general, the determination of whether property is 3-year recovery property, 5-year recovery property, etc., in the hands of the lessor will be based on the characterization of the property in the hands of the owner as determined without regard to the section 168(f)(8) lease. Thus,

for example, property which is public utility property or RRB replacement property absent the section 168(f)(8) lease will be characterized as such in the hands of the lessor for purposes of section 168(f)(8). However, with respect to RRB replacement property, the transitional rule of section 168(f)(3) shall be inapplicable to the lessor. In addition, any election under section 168(b)(3) by the lessor with respect to the class of recovery property to which the qualified leased property is assigned shall apply to the leased property in determining the term of the lease. A lease term that does not exceed the term required to satisfy the minimum lease term of this paragraph will be deemed to comply with the maximum lease term described in paragraph (b) if such minimum lease term exceeds such maximum lease term.

(d) *Examples.* The application of this section may be illustrated by the following examples:

*Example (1).* X Corp. (as lessee) and Y Corp. (as lessor) enter into a lease which they elect to be treated under section 168(f)(8) with respect to a chemical manufacturing facility that will also generate steam for use in the production of electricity. The assets comprising the chemical plant are described in ADR guideline class 28.0 (midpoint life of 9.5 years), and the assets comprising the steam plant are described in ADR class 00.4 (midpoint life of 22 years). To satisfy the maximum lease term requirement of section 168(f)(8)(B)(iii)(II) and §5c.168 (f)(8)–5(b), the lease term may not exceed 14.25 years (150 percent of the 9.5 year midpoint life of the chemical plant).

*Example (2).* The facts are the same as in example (1) except that the chemical plant and the steam plant are the subject of separate leases. For purposes of section 168(f)(8)(B)(iii)(II) and §5c.168(f)(8)–5 (b), the maximum term of the lease with respect to the chemical plant is 14.25 years (150 percent of 9.5 years) and the maximum term of the lease with respect to the steam plant is 33 years (150 percent of 22 years).

[T.D. 7791, 46 FR 51907, Oct. 23, 1981; 50 FR 13020, Apr. 2, 1985]

**§5c.168(f)(8)–6 Qualified leased property.**

(a) *Basic rules—(1) In general.* An agreement shall be treated as a section 168(f)(8) lease only if the property which is leased is qualified leased property. Qualified leased property is re-

covery property as defined in section 168(c) and is either—

(i) Except as provided in subparagraph (2), new section 38 property of the lessor which is leased no later than 3 months after the date the property was placed in service (or prior to November 14, 1981, if the property was placed in service after December 31, 1980, and before August 14, 1981) and which, if acquired by the lessee, would have been new section 38 property of the lessee, or

(ii) Property which is a qualified mass commuting vehicle (as defined in section 103(b)(9)) and which is financed in whole or in part by proceeds from an issue of obligations the interest on which is excludable from income under section 103(a).

(2) *Sale and leaseback arrangement.* (i) Where the leased property is purchased, directly or indirectly, by the lessor from the lessee (or a party related to the lessee), the property will not be qualified leased property unless the property was (or would have been) new section 38 property of the lessee and was purchased and leased no later than 3 months after the date the property was placed in service by the lessee (or prior to November 14, 1981, if the property was placed in service by the lessee after December 31, 1980 and before August 14, 1981) and with respect to which the lessor's adjusted basis does not exceed the adjusted basis of the lessee (or a party related to the lessee) at the time of the lease. If the lessor's adjusted basis in the property exceeds the seller's adjusted basis with respect to the property at the beginning of the lease, the property will not be qualified leased property.

(ii) For purposes of this paragraph (a)(2) and paragraph (b)(3)(ii) of this section, transactional costs with respect to a sale and leaseback arrangement that are not currently deductible shall be allocated to the lease agreement (and not included in the lessor's adjusted basis with respect to the property) and amortized over the term of the lease. These costs include legal and investment banking fees and printing costs.

(iii) The application of this paragraph (a)(2) may be illustrated by the following examples:

*Example (1).* X, an airline, contracts to have an airplane constructed for a fixed price of \$10 million. Prior to completion of construction of the airplane, the value of the airplane increases to \$11 million. X buys the airplane at the contract price of \$10 million and, before it is placed in service, sells the airplane at its fair market value of \$11 million to Y and then leases it back. The lease will not qualify for safe harbor protection under section 168(f)(8) because the lessor's adjusted basis in the airplane exceeds the lessee's adjusted basis. This result obtains even though the airplane qualifies as new section 38 property of X airline.

*Example (2).* Assume the same facts as in example (1) except that, prior to completion of the construction of the airplane, X assigns its contract to Y for \$1 million, and Y thereafter buys the airplane at the contract price of \$10 million. The acquisition by Y is treated as an indirect purchase from the lessee. Because Y's adjusted basis in the airplane would exceed the lessee's adjusted basis, the lease will not qualify under section 168(f)(8).

(b) *Special rules*—(1) *New section 38 property.* (i) New section 38 property is section 38 property described in subsection (b) of section 48 and the regulations thereunder other than a qualified rehabilitated building (within the meaning of section 48(g)(1)). Qualified leased property must be new section 38 property at the beginning of the lease and must continue to be section 38 property in the hands of the lessor and the lessee throughout the lease term. The fact that the lessee used the property within the 3-month period prior to the lease will not disqualify the property as new section 38 property of the lessee.

(ii) The application of this paragraph (b)(1) may be illustrated by the following examples:

*Example (1).* N is a hospital exempt from Federal income tax and wishes to purchase certain equipment for use in furtherance of its exempt functions (*i.e.*, other than for use in an unrelated trade or business). O, a qualified lessor as defined in § 5c.168(f)(8)–3(a), acquires the property and leases it to N. Since the equipment would not be new section 38 property of N if N had acquired it by virtue of section 48(a)(4) (relating to exception from definition of section 38 property for certain property used by certain tax-exempt organizations), the equipment is not qualified leased property and the lease does not qualify under section 168(f)(8). Whether O is considered the owner of the property for Federal tax law purposes will be determined without regard to the provisions of section 168(f)(8).

*Example (2).* P Corp. is constructing progress expenditure property as defined in section 46(d)(2) for R Corp. Progress expenditure property is property which it is reasonable to believe will be section 38 property in the hands of the taxpayer when it is placed in service. Before the date that the property is placed in service (as defined in § 5c.168(f)(8)–6(b)(2)(i)), the property is not new section 38 property. Accordingly, progress expenditure property cannot be qualified leased property.

*Example (3).* R Corp., a foreign railroad, acquires new rolling stock and enters into a sale and leaseback transaction with B Corp., a domestic corporation. R uses the rolling stock within and without the United States, but predominantly outside the United States within the meaning of section 48(a)(2)(A). Section 48(a)(2)(B)(ii) is inapplicable to R because R is neither a domestic railroad corporation nor a United States person; therefore, the rolling stock cannot be section 38 property to R. The property is not qualified leased property.

(2) *Placed in service.* (i) Property shall be considered as placed in service at the time the property is placed in a condition or state of readiness and availability for a specifically assigned function. If an entire facility is leased under one lease, property which is part of the facility will not be considered placed in service under this rule until the entire facility is placed in service. If the lessee claims any investment tax credit or ACRS deductions with respect to any component which is part of an entire facility that is subsequently leased, the lessee must file an amended return within the time prescribed in paragraph (b)(2)(ii) of this section in which it foregoes its claim to the investment tax credit and ACRS deductions. If such amended return may not be filed because the time for filing a claim for refund with respect to any component under section 6511 has expired, each component of the facility will be considered as placed in service at the time the individual component is placed in a condition or state of readiness and availability for a specifically assigned function and not when the entire facility is placed in service.

(ii) For purposes other than determining whether property is qualified leased property, property subject to a lease under section 168(f)(8) will be deemed to have been placed in service not earlier than the date such property is used under the lease. If the lessee

claims any investment tax credit or ACRS deductions with respect to property placed in service under a lease, the lessee must file an amended return within 3 months following the execution of the lease agreement in which the lessee foregoes its claim to the investment tax credit and ACRS deductions with respect to the leased property or the election under section 168(f)(8) will be void.

(iii) The application of this paragraph (b)(2) may be illustrated by the following examples:

*Example (1).* X Corp. acquires equipment on December 31, 1982, and places the equipment in service. X's taxable year ends December 31. On March 20, 1983, X sells the equipment to Y Corp. and leases it back in a transaction that qualifies under section 168(f)(8). The property is considered to be new section 38 property to X under paragraph (b)(1). X is not allowed any investment tax credit or ACRS deductions with respect to the property in 1982 because the property is not considered to have been placed in service for purposes other than determining whether it is qualified leased property until it is used under the lease under subdivision (ii) of this subparagraph (2). If X has claimed credits or deductions on its 1982 return, it must file an amended return for 1982 within 3 months following the execution of the lease agreement or the election will be void.

*Example (2).* In March 1985, K Corp. completes reconditioning of a machine, which it constructed and placed in service in 1982 and which has an adjusted basis in 1985 of \$10,000. The cost of reconditioning amounts to an additional \$20,000. K would be entitled to a basis of \$20,000 in computing its qualified investment in new section 38 property for 1985. In May 1985, K enters into a sale and lease-back transaction with L Corp. with respect to the reconditioned parts of the machine that are new section 38 property to K. K and L elect to have section 168(f)(8) apply. Assuming that the adjusted basis of the leased property is the same to L as it is to K, the property qualifies as qualified leased property under section 168(f)(8)(D)(ii) and L is considered the tax owner of the property. Since, for purposes other than determining whether property is qualified leased property, the property is deemed originally placed in service not earlier than the date the property is used under the lease, the property is new section 38 property to L and L may claim the investment tax credit (and ACRS deductions) with respect to the leased property.

(3) *Qualified mass commuting vehicle.*

(i) A qualified mass commuting vehicle

as defined in section 103(b)(9) will constitute qualified leased property for purposes of section 168(f)(8)(D)(iii) and this section provided all of the following requirements are met:

(A) At least part (as, for example, 5 percent) of the financing for the purchase of such vehicle must be derived from proceeds of obligations the interest on which is excludable from income under section 103(a)(1) (whether or not such obligations are described in section 103(b)(4)(I));

(B) The vehicle must be recovery property (*i.e.*, it must have been first placed in service by the lessee after December 31, 1980); and

(C) The vehicle must not have been previously leased under a section 168(f)(8) lease by the lessee.

A qualified mass commuting vehicle that is qualified leased property may be leased under section 168(f)(8) at any time after December 31, 1980. The requirement of paragraph (b)(3)(i)(A) of this section may be satisfied where the vehicles leased under a section 168(f)(8) lease are refinanced with proceeds of an obligation the interest on which is excludable from income under section 103(a)(1).

(ii) Where the leased property is purchased, directly or indirectly, by the lessor from the lessee (or a party related to the lessee), the property will not qualify under this subsection unless the lessor's adjusted basis in the property does not exceed the adjusted basis of the lessee (or related party) at the time of the execution of the lease. The adjusted basis of property to a lessee (or related party) shall be determined under Part II of Subchapter O of Chapter I of the Code for purposes of determining gain, except that the adjustment described in section 1016(a)(3) and § 1.1016-4 need not be made for property acquired during calendar year 1981 and leased no later than March 1, 1982.

(iii) In a transaction characterized as a lease under section 168(f)(8), the lessor's adjusted basis may not include that portion, if any, of the cost of the vehicle to the lessee (or related party) that is financed, directly or indirectly, with an Urban Mass Transportation

Administration (UMTA) grant (excluding a grant under the interstate transfer provision of the Federal-Aid Highway Act (FAHA)), a FAHA grant, or any other Federal grant. Where a vehicle is included as part of an UMTA-funded project, 80 percent of the vehicle's cost will be deemed to be financed with an UMTA grant and 20 percent will be deemed to be financed from non-Federal sources without regard to whether the UMTA funds or the non-Federal funds are traceable to any particular vehicle included within the project. For purposes of this subparagraph and paragraph (b)(3)(ii) of this section, amounts originating from non-Federal sources which are paid or incurred with respect to leased property by a State or political subdivision of the State (or political subdivision created by the joint authorization of two or more States) shall be taken into account in computing the lessee's adjusted basis in the leased property as if the lessee had paid or incurred such amounts.

(iv) If a vehicle is purchased pending approval of an UMTA grant, the lessor's unadjusted basis in the vehicle may equal the lessee's unadjusted basis unreduced by any subsequently approved UMTA grant; however, if an UMTA grant is later approved and the vehicle is included as part of an UMTA-funded project, except as provided hereinafter in this subparagraph, the lease shall terminate with respect to an undivided 80 percent interest in the vehicle. For the Federal income tax consequences of the termination of a lease, see § 5c.168(f)(8)-8. If such a subsequently approved UMTA grant is used to purchase additional qualified mass commuting vehicles, the portion of each vehicle deemed to be allocable to non-UMTA financing (*i.e.*, 20 percent) may be leased under section 168(f)(8). If a vehicle is purchased pending approval of an UMTA grant and leased under section 168(f)(8), the lease will not be deemed to have terminated with respect to 80 percent of the vehicle when the UMTA grant is later approved if the total interest leased before the grant is approved did not exceed 20 percent of the lessee's adjusted basis in the vehicle (unadjusted basis prior to March 1, 1982) unreduced by any subse-

quently approved UMTA grant. For purposes of this subparagraph and paragraph (b)(3)(iii) of this section, the allocation principles applicable to UMTA grants shall apply in the case of FAHA grants except that 85 percent and 15 percent shall be substituted for 80 percent and 20 percent, respectively. Similar allocation rules shall also apply to other Federal grants used to finance the acquisition of qualified mass commuting vehicles.

(v)(A) Notwithstanding the provisions of § 5c.168(f)(8)-2(a)(3)(iii), the lessee in a transaction to which this paragraph (b)(3) applies is not required to file an information return or a statement concerning its election under section 168(f)(8).

(B) Notwithstanding the provisions of § 5c.168(f)(8)-2(a)(5), if the transfer of a qualified mass commuting vehicle is not otherwise a disqualifying event, the transferee is not required to file the statement mentioned therein.

(C) The fact that a qualified mass commuting vehicle is not section 38 property because it is used by an exempt entity will not disqualify the lease under § 5c.168(f)(8)-8(b)(4); however, a disqualifying event will occur, and the agreement will cease to be characterized as a lease under section 168(f)(8), with respect to a vehicle which (1) ceases to be a qualified mass commuting vehicle or (2) would cease to be section 38 property if used by a taxable entity as, for example, a vehicle used predominantly outside the United States. For the Federal income tax consequences of a disqualifying event, see § 5c.168(f)(8)-8.

(vi) The lessor of a qualified vehicle will not be allowed an investment tax credit with respect to it under section 38.

(vii) The application of this paragraph (b)(3) may be illustrated by the following examples:

*Example (1).* On July 1, 1981, a unit of city X, X Transit Authority (XTA), purchases 100 buses after receiving an UMTA grant for 80 percent of their purchase price. Fifteen percent of the purchase price is financed with a combination of State and local governmental grants and 5 percent is financed with proceeds from an issue of tax-exempt obligations described in section 103(b)(4)(I). Because UMTA financed an 80 percent interest

in the 100 buses, XTA may lease under section 168(f)(8) only a 20 percent interest in each bus. If XTA were to lease 100 percent of 20 buses, only 20 percent of such buses would be deemed to be leased under a safe harbor lease.

*Example (2).* The facts are the same as in example (1) except that UMTA has not yet approved XTA's application in 1981. Pending the UMTA approval, XTA purchases and places in service 20 buses in July 1981. The 20 buses are financed with tax-exempt obligations described in section 103(b)(4)(I). On December 15, 1981, XTA sells a 100 percent interest in these 20 buses to Corporation M and leases them back under a lease in which the parties elect to have the provisions of section 168(f)(8) apply. M is a calendar-year taxpayer and claims an ACRS deduction with respect to the buses on its return for taxable year 1981. On July 1, 1982, UMTA approves XTA's grant application, thus enabling XTA to purchase an additional 80 buses. Because 80 percent of the original 20 buses are deemed to have been financed by UMTA beginning on July 1, 1982, the safe harbor lease terminates with respect to an undivided 80 percent interest in the 20 buses. If XTA would be considered the owner of the buses without regard to section 168(f)(8), the termination will result in a deemed sale of an undivided 80 percent interest in the 20 buses by M to XTA. The amount realized by M on the sale will include a proportionate part of the outstanding amount of M's debt plus the sum of any other consideration received by M. M will realize gain or loss, depending upon its basis, with applicable section 1245 recapture. However, XTA may lease the 20 percent interest in the 80 new buses it purchased in 1982 which is deemed to have been financed with non-Federal funds.

*Example (3).* The facts are the same as in example (2) except that the grant approved by UMTA is used to purchase and renovate a bus garage facility. Eighty percent of the original 20 buses are deemed to have been financed by UMTA beginning on July 1, 1982. The lease would still terminate with respect to an undivided 80 percent interest in the vehicles. XTA cannot lease the garage facility under 168(f)(8) because it does not constitute a qualified mass commuting vehicle.

*Example (4).* The facts are the same as in example (2) except that on December 15, 1981, XTA sells and leases back only a 20 percent interest in the 20 buses acquired in July 1981. When the UMTA grant is later approved, the lease will not terminate with respect to any portion of the 20 buses. In addition, XTA may lease the 20 percent interest in the 80 new buses purchased in 1982 and deemed to have been financed with non-Federal funds.

*Example (5).* On August 1, 1982, UMTA approves a grant for a major 5-year capital expenditure program to improve city Y's rapid rail transit system. None of the funds relat-

ing to this UMTA-funded project, provided either by UMTA or by city Y, will be used to purchase qualified mass commuting vehicles. Instead, a number of rapid rail cars and buses will be purchased entirely with funds provided with a combination of grants by the State and city governments and of proceeds from an issue of tax-exempt obligations described in section 103(a). Because none of the rapid rail cars and buses are included as part of the UMTA-funded project, no part of them is deemed to be financed by UMTA. If at least 5 percent of the cost of the qualified mass commuting vehicles is provided by tax exempt obligations under section 103(a), the vehicles will be qualified leased property in their entirety.

*Example (6).* City Z has a mass transit agency (ZTA) which purchases on July 1, 1982, 10 buses for which it pays \$1,000,000, 95 percent of which is derived from grants from city Z and 5 percent from tax exempt obligations described in section 103(a). The buses have a useful life within the meaning of §1.167(a)–1(b) of 10 years and their salvage value is zero. On July 1, 1983, ZTA sells these buses to corporation P and leases them back in a transaction which the parties elect to have treated as a lease under section 168(f)(8). At the time of the sale and lease-back, ZTA's adjusted basis in the 10 buses under section 1016(a)(3) and §1.1016–4 is \$900,000 (\$1,000,000 cost less \$100,000 of depreciation sustained, computed on a straight-line basis). Before the transaction will qualify under section 168(f)(8) and §5c.168(f)(8)–6(b)(3)(ii), P's adjusted basis in the vehicles may not exceed ZTA's basis, or \$900,000. Assuming that the transaction qualifies under section 168(f)(8) and that corporation P is a calendar year taxpayer, P may claim ACRS deductions for 1982 of \$135,000 (15 percent of \$900,000).

*Example (7).* The facts are the same as in example (6) except that the sale and lease-back transaction is closed on December 31, 1982. P's adjusted basis in the vehicles may not exceed ZTA's basis, or \$950,000 (\$1,000,000 cost less \$50,000 of depreciation sustained, computed on a straight-line basis).

*Example (8).* The facts are the same as in example (6) except that ZTA purchases the buses on June 1, 1981, and enters into the sale and leaseback transaction with corporation P on December 31, 1981. Under §5c.168(f)(8)–6(b)(3)(ii), no adjustment is made to ZTA's basis in the buses for depreciation sustained. Therefore, P's basis in the buses may equal ZTA's cost of \$1,000,000.

*Example (9).* On July 1, 1981, a unit of city W, W Transit Authority (WTA), purchases 100 buses with local grants derived entirely from a city W sales tax. The buses do not constitute qualified leased property under §5c.168(f)(8)–6(b)(3) because no part of the financing for their purchase was derived from the proceeds of tax exempt obligations.

*Example (10).* The facts are the same as in example (9) except that on November 1, 1981, WTA borrows 5 percent of the cost of the buses and pledges them as security. The interest on WTA's obligation is excludable from income under section 103(a)(1). On December 31, 1981, WTA sells to T Corp. all 100 buses and leases them back. Under § 5c.168(f)(8)-6(b)(3)(i), each bus is deemed to be financed with the proceeds of tax exempt obligations. Therefore, if the vehicles otherwise meet the definition of qualified leased property, all the vehicles will be qualified leased property under this section.

(4) *Foreign lessees.* In addition to the other provisions of this section, property which is leased under a section 168(f)(8) lease to a foreign person shall not be qualified leased property unless the gross income attributable to the property from all sources (determined without regard to section 872(a) or 882(b)) is effectively connected with a trade or business within the United States, and the taxable income, if any, attributable to the property is subject to tax under section 871(b)(1) or 882(a)(1). For this purpose, if income attributable to the property is not included in gross income of a foreign lessee, and is exempt from taxation, under sections 872 or 833, or if the income is otherwise exempt from taxation under any income tax convention to which the United States is a party, then the property shall not be qualified leased property.

(5) *Other rules.* (i) Qualified leased property may include undivided interests in property or property regardless of whether or not it is considered separate property under State or local law. If property subject to a section 168(f)(8) lease is later determined not to be qualified leased property, disqualification of the lease under section 168(f)(8) will apply only as to that property.

(ii) The application of this paragraph (b)(5) may be illustrated by the following examples:

*Example (1).* On July 1, 1981, X Corp. contracts to have a manufacturing facility constructed for use in its business. Construction of the facility is completed on July 1, 1982, and the facility is deemed to be placed in service as of that date under § 5c.168(f)(8)-6(b)(2)(i). The facility is comprised of a mixture of new section 38 property and buildings that do not qualify as section 38 property. On August 1, 1982, X sells the new section 38 property in the facility to Y and leases it

back under an agreement in which the parties elect to be treated as a lease described in section 168(f)(8). Assuming that the other requirements of this paragraph are met, the new section 38 property contained in the facility will be qualified leased property. If it is later determined that property subject to the section 168(f)(8) lease is not new section 38 property (and thus not qualified leased property), the safe harbor protection will be lost only as to that property.

*Example (2).* X Corp. acquires a certain piece of equipment (which is new section 38 property) for use in its business. Within 3 months, X sells a 70 percent undivided interest in the property to lessor A and a 10 percent undivided interest in the property to lessor B and leases both portions back under separate section 168(f)(8) leases. The investment tax credit and ACRS deductions associated with the property will be divided among X, lessor A, and lessor B, on a basis of 20 percent, 70 percent, and 10 percent, respectively.

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56150, Nov. 13, 1981; T.D. 7800, 46 FR 63258, Dec. 31, 1981]

#### **§ 5c.168(f)(8)-7 Reporting of income, deductions and investment tax credit; at risk rules.**

(a) *In general.* The fact that the lessor's payments of interest and principal and the lessee's rental payments under the lease are not equal in amount will not prevent the lease from qualifying under section 168(f)(8). However, see paragraph (b) for special requirements in sale and leaseback transactions. In determining the parties' income, deductions, and investment tax credit under the lease, the rules in paragraphs (c) through (g) of this section shall apply regardless of the overall method of accounting otherwise used by the parties.

(b) *Requirements for sale and leaseback transaction.* If the property leased is financed by the lessee (or a related party of the lessee) in a sale and leaseback transaction, the lease will not qualify under section 168(f)(8) unless—

(1) The term of the lessor's purchase money obligation is coterminous with the term of the lease, and

(2) The lessor's obligation bears a reasonable rate of interest. For this purpose, a rate of interest shall be presumed to be reasonable if, on the date the agreement is executed, it is within 3 percentage points of (i) the rate in effect under section 6621, the prime rate in effect at any local commercial bank,

or the most recent applicable rate determined by the Secretary under § 1.385–6 (e)(2)(i), or (ii) an arm's-length rate as defined in § 1.482–2, or (iii) any rate between any two of the rates described by subdivisions (i) and (ii) of this paragraph(b)(2).

(c) *Interest deductions and income*—(1) *Deductibility from income.* In determining the amount of interest that a lessor may deduct in a taxable year with respect to its purchase money obligation given to the lessee or to a third party creditor, the lessor may not claim a deduction that would be—

(i) Greater than a deduction that would be allowed to an accrual basis taxpayer under a level-payment mortgage, amortized over a period equal to the term of the lessor's obligation, or

(ii) Less than a deduction that would be allowed to an accrual basis taxpayer under a straight line amortization of the principal over the term of the lessor's obligation.

In cases in which the property is not financed by the lessee or a party related to the lessee, the computation of the interest deduction may take into account fluctuations in the interest rate which are dependent on adjustments in the prime rate or events outside the control of the lessor and the third party creditor.

(2) *Includibility in income.* The lessee shall include interest on the lessor's purchase money obligation in income at the same time and in the same amount as the lessor's interest deductions, as determined under paragraph (c)(1).

(d) *Rental income and deductions*—(1) *Deductibility from income.* The amount of the lessee's rent deduction under a section 168(f)(8) lease with respect to any taxable year shall be a pro rata portion of the aggregate amount required to be paid by the lessee to the lessor under the terms of the lease agreement. If the lessee is required to purchase the leased property at the end of the lease term, or if the lessor has an option to sell the property to the lessee, rent shall not include the lesser of—

(i) The amount of the lessee's purchase obligation, whether fixed by the terms of the lease agreement or conditioned on the exercise of the lessor's

option to sell the property to the lessee, or

(ii) The fair market value of the property at the end of the lease term determined at the beginning of the lease term.

For this purpose, fair market value shall be determined without taking into account any increase or decrease for inflation or deflation during the lease term. Rent deductions may be adjusted pursuant to the terms of the lease agreement to account for fluctuations which are dependent on events outside the control of the lessor and lessee, such as a change in the interest rate charged by a third party creditor of the lessor on the debt incurred to finance the purchase of the leased property.

(2) *Includibility in income.* The lessor shall include rent in income as follows:

(i) In the case of prepayments of rent, the earlier of when such rent is paid by the lessee or accrued under the lease, and

(ii) In the case of other rent, at the same time and in the same amount as the lessee's rent deductions, as determined under paragraph (d)(1).

(e) *ACRS deductions.* The deductions that the lessor is allowed under section 168(a) with respect to property subject to a section 168(f)(8) lease shall be determined without regard to the limitation in section 168(f)(10)(B)(iii). The recovery class of qualified leased property in the hands of the lessor shall be determined by the character of the property in the hands of the owner of the property without regard to section 168(f)(8). Any elections under section 168(b)(3) by the lessor with respect to the class of recovery property to which the qualified leased property is assigned shall apply to the leased property. However, with respect to RRB replacement property, the transitional rule of section 168(f)(3) shall be inapplicable to the lessor.

(f) *At risk requirements.* The amount of the investment credit and ACRS deductions that a lessor shall be allowed with respect to the leased property shall be limited to the extent the at risk rules under the investment tax credit provisions and section 465 apply to the lessee or to the lessor. In determining the amount the lessee would be



at risk, the at risk rules will be applied as if the lessee had not elected to have section 168(f)(8) apply. Thus, for example, if, without regard to section 168(f)(8), an individual lessee would be treated as the owner of the leased property for Federal tax law purposes, the lessor under a section 168(f)(8) lease would be allowed ACRS deductions or investment tax credits with respect to the property only to the extent that the lessee may have claimed them had the parties not elected treatment under section 168(f)(8). In addition, the ACRS deductions and investment tax credits that a lessor is allowed with respect to the property are further limited to the extent that the at risk rules apply to the lessor as owner of the property under the section 168(f)(8) lease. If the lessor and the lessee are subject to the at risk rules, the lessor is allowed only the lesser of the ACRS deductions and investment tax credits allowable to the lessor and the lessee.

(g) *Limitation on section 48(d) amount.* If in a sale and leaseback transaction the lessor elects pursuant to section 48(d) to treat the lessee (which is the user of the property) as having acquired the property for purposes of claiming the investment tax credit, the lessee shall be treated as acquiring the property for an amount equal to the basis of the property to the lessor (and not for an amount equal to its fair market value). The investment tax credit allowable to the lessee is further limited to the extent the at risk rules apply to either the lessor or to the lessee. See paragraph (f) of this section.

(h) *Examples.* The application of the provisions of this section may be illustrated by the following examples.

*Example (1).* Y, a qualified lessor, acquires a piece of equipment which is qualified leased property for \$1 million and leases it to X under a lease which the parties properly elect to have characterized as a lease described in section 168(f)(8). The equipment has a 10-year economic life and falls within the 5-year ACRS class. Under the terms of the lease, X, the lessee-user, is obligated to pay Y nine annual payments of \$10,000 and, at the end of the lease term, Y has the option to sell the property to X for \$2,160,000. Under § 5c.168(f)(8)-7(d), the aggregate payments required to be made by X under the lease are \$2,250,000 (\$90,000 rent plus \$2,160,000 option price) and are treated as rent to Y (less a reasonable estimate for the residual value of

the property) and taxable as such. Assuming a reasonable estimate of the residual value is zero, the full \$2,250,000 will be treated as rent, and under § 5c.168(f)(8)-7(d), such amount is deductible by X and includible in Y's income ratably over the term of the lease, *i.e.*, at a rate of \$250,000 per year (\$2,250,000 divided by 9).

*Example (2).* The facts are the same as in example (1) except that under the terms of the lease X is obligated to make rental payments of \$100,000 for each of the first 5 years of the lease and \$300,000 for each of the 4 remaining years under the lease. Further, X has an option to purchase the equipment for \$1.00 at the end of the lease term. Pursuant to § 5c.168(f)(8)-7(d), X's aggregate rental payments are deductible by X and are includible in Y's income ratably over the term of the lease. Thus, the annual rental payments are deemed to be \$188,000 per year (\$1,700,000 divided by 9).

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56150, Nov. 13, 1981]

#### **§ 5c.168(f)(8)-8 Loss of section 168(f)(8) protection; recapture.**

(a) *In general.* Upon the occurrence of an event that causes an agreement to cease to be characterized as a lease under section 168(f)(8), the characterization of the lessor and lessee shall be determined without regard to section 168(f)(8).

(b) *Events which cause an agreement to cease to be characterized as a lease.* A disqualifying event shall cause an agreement to cease to be treated as a lease under section 168(f)(8) as of the date of the disqualifying event. A disqualifying event shall include the following:

(1) The lessor sells or assigns its interest in the lease or in the qualified leased property in a taxable transaction.

(2) The failure by the lessor to file a copy of the information return (or applicable statement) with its income tax return as required in § 5c.168(f)(8)-2(a)(3)(iii).

(3) The lessee (or any transferee of the lessee's interest) sells or assigns its interest in the lease or in the qualified leased property in a transaction not described in § 5c.168(f)(8)-2(a)(6) and the transferee fails to execute, within the prescribed time, the consent described in § 5c.168(f)(8)-2(a)(5), or either the lessor or the transferee fail to file statements with their income tax returns as required by that paragraph.

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(4) The property ceases to be section 38 property as defined in § 1.48–1 in the hands of the lessor or lessee, for example, due to its conversion to personal use or to use predominantly outside the United States, or to use by a lessee exempt from Federal income taxation.

(5) The lessor ceases to be a qualified lessor by becoming an electing small business corporation or a personal holding company (within the meaning of section 542(a)).

(6) The minimum investment of the lessor becomes less than 10 percent of the adjusted basis of the qualified leased property as described in section 168(f)(8)(B)(ii) and § 5c.168(f)(8)–4.

(7) The lease terminates.

(8) The property becomes subject to more than one lease for which an election is made under section 168(f)(8).

(9) Retirements and casualties. [Reserved]

(10) The property is transferred in a bankruptcy or similar proceeding and the lessor fails either to furnish the appropriate notification or to file a statement with its income tax return as required by § 5c.168(f)(8)–2(a)(6).

(11) The property is transferred in a bankruptcy or similar proceeding and not all lenders with perfected and timely interests in the property specifically exclude or release the Federal income tax ownership of the property as required under § 5c.168(f)(8)–2(a)(6)(iii.)

(12) The property is transferred subsequent to a bankruptcy or similar proceeding and the lessor fails to furnish notice to the transferee prior to the transfer or fails to file a statement with its income tax return, and either the lessor fails to secure the transferee's consent or the lessor or the transferee fail to file statements with their returns.

(13) The property is leased under the provisions of section 168(f)(8)(D)(iii) and § 5c.168(f)(8)–6(b)(3) and ceases to be a qualified mass commuting vehicle.

(14) The failure by the lessor to file the required information return described in § 5c.168(f)(8)–2 (a)(3)(ii) by January 31, 1982, unless the lessee files such return by January 31, 1982.

(c) *Recapture.* The required amount of recapture of the investment tax credit and of accelerated cost recovery deductions after a disqualifying event shall

be determined under sections 47 and 1245, respectively.

(d) *Consequences of loss of safe harbor protection.* The tax consequences of a disqualifying event depend upon the characterization of the parties without regard to section 168(f)(8). If the lessee would be the owner of the property without regard to section 168(f)(8), the disqualifying event will be deemed to be a sale of the qualified leased property by the lessor to the lessee. The amount realized by the lessor on the sale will include the outstanding amount (if any) of the lessor's debt on the property plus the sum of any other consideration received by the lessor. A disposition that results from a disqualifying event shall not be treated as an installment sale under section 453.

(e) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

*Example (1).* M Corp. and N Corp. enter into a sale and leaseback transaction in which the leaseback agreement is characterized as a lease under section 168(f)(8) and M is treated as the lessor. In the second year of the lease, M becomes an electing small business corporation under subchapter S. The agreement ceases to be treated as a lease under section 168(f)(8) as of the date of the subchapter S election. Without respect to section 168(f)(8), N would be considered the owner of the property. The disqualification of M will be treated as a sale of the qualified leased property from M to N for the amount of the purchase money debt on the property then outstanding. M will realize gain or loss, depending upon its basis, with applicable investment tax credit and section 1245 recapture. N will acquire the property with a basis equal to the amount of the outstanding obligation. The property will not be used section 38 property to N under § 1.48–3(a)(2).

*Example (2).* Q Corp. (as lessor) and P Corp. (as lessee) enter into a lease that is characterized as a lease under section 168(f)(8). The lease has a 6-year term. P has no option to renew the lease or to purchase the property. At the end of 6 years, if P would be considered the owner of the property without regard to section 168(f)(8), upon the termination of the lease the property will be deemed to be sold by Q to P for the amount of the purchase money debt outstanding with respect to the property.

[T.D. 7791, 46 FR 51907, Oct. 23, 1981, as amended by T.D. 7795, 46 FR 56150, Nov. 13, 1981; T.D. 7800, 46 FR 63259, Dec. 31, 1981]

Internal Revenue Service, Treasury

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**§5c.168(f)(8)-9 Pass-through leases—transfer of only the investment tax credit to a party other than the ultimate user of the property. [Reserved]**

**§5c.168(f)(8)-10 Leases between related parties. [Reserved]**

**§5c.168(f)(8)-11 Consolidated returns. [Reserved]**

**§5c.1305-1 Special income averaging rules for taxpayers otherwise required to compute tax in accordance with §5c.1256-3.**

(a) *In general.* If an eligible individual (as defined in section 1303 and the regulations thereunder) is described in the first sentence of §5c.1256-3(a), chooses the benefits of income averaging and otherwise complies with the special rules under section 1304 and the regulations thereunder, and has averagable income (as defined in section 1302 and the regulations thereunder) in excess of \$3,000, then the individual shall compute the tax under section 1301 as provided in this section. The computation under this section shall be in lieu of the computation under §5c.1256-3.

(b) *Computation of tax.* The individual shall compute the tax under section 1301 as follows:

*Step (1).* Compute tax under section 1301 and the regulations thereunder on all taxable income, including gains or losses on regulated futures contracts subject to section 1256(a) and the regulations thereunder, using rates applicable to the taxpayer for the taxable year which includes June 23, 1981.

*Step (2).* Compute tax under section 1301 and the regulations thereunder on all taxable income, including gains or losses on regulated futures contracts subject to section 1256(a) and the regulations thereunder, using rates applicable to the taxpayer for taxable years beginning in 1982.

*Step (3).* Compute the percentage of adjusted gross income attributable to all sources except regulated futures contracts subject to section 1256(a) and the regulations thereunder.

*Step (4).* Compute the percentage of adjusted gross income attributable to regulated futures contracts subject to section 1256(a) and the regulations thereunder. Both the percentage in Step (3) and the percentage in Step (4) are to be rounded to the nearest percent. The sum of both percentages must equal 100 percent.

*Step (5).* Multiply the result of Step (1) with the result of Step (3).

*Step (6).* Multiply the result of Step (2) with the result of Step (4).

*Step (7).* Add the result of Step (5) and the result of Step (6). This is the tax for the individual under section 1301 for the taxable year which includes June 23, 1981.

(c) *Option to defer tax.* If an individual computes the tax under section 1301 as provided in paragraph (a) of this section, the individual may also opt to pay part or all of the deferrable tax under income averaging (as defined in paragraph (d) of this section) for the taxable year which includes June 23, 1981, in 2 or more, but not more than 5, equal installments in accordance with this section. Such individual may not opt to pay part or all of the deferrable tax in installments under §5c.1256-3. An individual opting to defer payment must attach a statement to Form 6781 indicating the computation of deferrable tax under income averaging, the number of installments in which the individual opts to pay the deferrable tax under income averaging, and the amount of each such payment.

(d) *Deferrable tax under income averaging.* The deferrable tax under income averaging is the excess of—

(1) The tax for the taxable year which includes June 23, 1981, computed pursuant to paragraph (b) of this section, over

(2) The tax for the taxable year which includes June 23, 1981, computed pursuant to paragraph (b) of this section, except that pre-transitional year gain or loss (as described in §5c.1256-2(g)) is omitted for purposes of recomputing the percentage in Step (4). As computed under this subparagraph (2), the sum of the percentage in Step (3) and Step (4) will not equal 100 percent.

(e) *Rules of application.* The provisions of §5c.1256-3 (c), (f), (g), (h), (i), and (j) shall apply in computing the tax and in determining the deferrable tax under income averaging under this section.

(f) *Examples.* The application of this section may be illustrated by the following examples:

*Example (1).* Individual A is a single, calendar year taxpayer with no dependents. A reported the following amounts for the following years on line 34 of Form 1040:

1977—\$80,000  
 1978—\$90,000  
 1979—\$100,000  
 1980—\$110,000

A reports the following amounts for the following lines on Form 1040 for 1981:

line 7—\$120,000  
 line 12—\$600,000  
 line 32b—\$19,000  
 line 33—\$1,000

The amount on line 12 is computed as follows: \$937,500 of gain is attributable to regulated futures contracts subject to section 1256(a). Of that total, 40 percent is short term capital gain (\$375,000) and 60 percent is long term capital gain (\$562,500). Of the long term capital gain, 40 percent is taxable (\$225,000). Therefore, A reports \$600,000 on line 12 (\$375,000+\$225,000).

The result of Step (1) is \$464,013.41. The result of Step (2) is \$337,051.52. The result of Step (3) is 17 percent. The result of Step (4) is 83 percent. The result of Step (5) is \$78,882.28. The result of Step (6) is \$279,752.76. The result of Step (7) is \$358,635.04. This is A's tax for 1981 under section 1301.

*Example (2).* The facts are the same as in Example (1), except that \$703,125 of the \$937,500 gain attributable to regulated futures contracts is pre-transitional year gain or loss (as described in §5c.1256-2(g)). A's tax for 1981 under section 1301 is \$358,635.04. A may opt to pay in installments a maximum of \$221,004.68 of the tax due in 1981. If A opts to defer the maximum amount and pay in 5 equal installments, A must pay for 1981 a tax of \$181,831.30. Each of the 4 succeeding installments is \$44,200.94 plus interest computed in accordance with §5c.1256-3(g)(3).

(Secs. 1305 and 7805 of the Internal Revenue Code of 1954 (78 Stat. 110, 26 U.S.C. 1305; 68A Stat. 917, 26 U.S.C. 7805); secs. 508(c) and 509 of the Economic Recovery Tax Act of 1981 (95 Stat. 333-335))

[T.D. 7826, 47 FR 38692, Sept. 2, 1982]

## **PART 5e—TEMPORARY INCOME TAX REGULATIONS, TRAVEL EXPENSES OF MEMBERS OF CONGRESS**

AUTHORITY: Secs. 280A(f)(4)(B) and 7805 of the Internal Revenue Code of 1954 (95 Stat. 1641, 26 U.S.C. 7805; 68A Stat. 917, 26 U.S.C. 7805).

### **§ 5e.274-8 Travel expenses of Members of Congress.**

(a) *In general.* Members of Congress (including any Delegate and Resident Commissioner) who are away from home within the meaning of section 162

(a), in the Washington, DC area, may elect in accordance with paragraph (f) of this section to deduct an amount described in paragraph (c) of this section as living expenses, without substantiation. A Member who elects under this section may not deduct any amount for the living expenses described in paragraph (b). A Member who does not make an election under this section must substantiate his expenses for living in Washington, DC in accordance with section 274 and §1.274-5.

(b) *Living expenses covered.* The amount allowed to be deducted without substantiation, pursuant to this section, for costs incurred for living in the Washington, DC area represents amounts expended for meals, lodging, and other incidental expenses. Meals include the actual cost of the food and expenses incident to the preparation and serving thereof. Lodging includes amounts paid for rent, care of premises, utilities, insurance and depreciation of household furnishings owned by the Member. In the case of a Member who lives in a residence owned by him in the Washington, DC area, the cost of lodging also includes depreciation on such residence. Other incidental expenses include laundry, cleaning, and local transportation. Local transportation includes travel within a 50 mile radius of Washington, DC, whether by private automobile, taxicab or other transportation for hire. Interest and taxes on personal property will not be considered expenses to be included within this paragraph.

(c)(1) *Amounts allowed without substantiation.* The amount that may be deducted pursuant to section 162 and these regulations is an amount equal to the product of the number of Congressional days in the taxable year, multiplied by the designated amount. The designated amount is—

(i) In the case of a Member who deducts interest and taxes attributable to the ownership of a personal residence in the Washington, DC area, two-thirds of the maximum amount of actual subsistence for Washington, DC payable pursuant to 5 U.S.C. 5702(c), or

(ii) In the case of a Member not described in paragraph (c)(1)(i), the maximum amount of actual subsistence for